

**AUDIT MANUAL**

**CHAPTER 11**

**Department Stores**

*Sales and Use Tax*



Department of Business Taxes  
*California State Board of Equalization*



## CHAPTER 11

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## CHAPTER 11

### DEPARTMENT STORES

**1100.00**

#### INTRODUCTION

**1101.00**

#### GENERAL

**1101.05**

This chapter is a guide for making audits to determine sales and use tax liability of department stores. Portions of the chapter are also appropriate for auditing other types of retail establishments such as furniture and appliance stores. This chapter does not cover all phases of the necessary audit work on any assignment; many department store audit procedures and techniques will not differ from those covered by other chapters of the Audit Manual and frequent references will be made to those chapters.

For our audit purposes, the outstanding characteristic of a department store is the wide variety of consumer goods which it sells at retail. In a sense, it is a grouping of many retail stores into a consolidated business operation under one management. There may be more than one place of business. In addition to departments owned by the business entity there often are departments owned by other persons. Tax liability for concession operations may be that of the department store or the concessionaire (Regulation 1699, Permits).

## **PRELIMINARY AUDIT PROCEDURE**

**1102.00**

### **GENERAL**

**1102.05**

The preliminary planning for an audit of a department store may well be the most important part of the procedure. The large number of departments within the store together with the high volume of transactions makes it mandatory that the auditor properly orient himself before embarking on detailed verification processes. Development of a good audit program is absolutely essential. Without such a program, excessive time will be expended and undue inconvenience imposed upon the business organization. Reference should be made to Chapter 4 of the Audit Manual for general guidance in starting an audit.

### **REVIEW OF PRIOR AUDIT**

**1102.10**

Preliminary work will include an examination of the district file with particular emphasis on a thorough review of any prior audit report and working papers. This review will be informative and an assistance in developing procedures for the current audit.

A good indication of the accuracy of the taxpayer's current reporting techniques may be obtained by computing the ratio of the totals of prior audit deductions and taxable sales to total sales (as audited). These percentages should then be compared with current ratios as reflected on the Form BT-414, Auditor's Work Sheet. This analysis will generally identify any areas needing special attention.

### **REQUEST FOR APPOINTMENT WITH TAXPAYER**

**1102.15**

A specific appointment should be requested by phone or mail with the treasurer or comptroller for a preliminary discussion of the proposed audit. The auditor may be referred later to an assistant who has direct responsibility for sales and use tax matters.

### **INITIAL MEETING WITH TAXPAYER**

**1102.20**

During the initial meeting with the taxpayer's representative, the auditor should review major record and document requirements and try to reach a mutual understanding regarding each phase of the audit. This first meeting is of utmost importance as the audit is a joint venture in which department store as well as State representatives participate. Both have a common goal in determining the correct amount of tax liability for the period under review and ascertaining how errors can be minimized in the future. Also, both are vitally interested in completing the audit in a reasonable time with minimum inconvenience to the taxpayer. *Should the taxpayer request a material postponement in the starting of the audit, it is incumbent upon the auditor to consider the necessity for securing a waiver and/or a claim for refund.*

### **SCOPE OF MATTERS TO BE DISCUSSED**

**1102.25**

Matters to be discussed at this time include such items as: (a) a mutually convenient date for starting the audit; (b) working space and facilities needed for the Board auditors; (c) the name and title of the store representatives with whom the auditor will coordinate his activities, and (d) the availability and location of records and supporting detail.

It is important that the store representative be apprised that tests will be used to verify the accuracy of the store's tax reporting. *Accordingly, a tentative understanding of the extent of any test periods to be used in the audit must be reached at an early date.*

At this time a good opportunity presents itself to settle the method of furnishing copies of working papers and related summaries to the taxpayer. Most of the larger taxpayers have copying machines that can be used for duplicate schedules.

## **DEPARTMENT STORES' INSTRUCTIONS TO THEIR EMPLOYEES**

**1102.30**

As a first step, the auditor should review the taxpayer's manual and written instructions pertaining to sales tax, policy on returned merchandise, adjustments, trade-ins, etc. This review should be made with the thought in mind that written policies do not always coincide with actual practice, as inexperienced employees may be unaware of the written policies. This is especially true in the preparation of sales slips and returned merchandise documents where unusual conditions are present.

## **INSPECTION OF TAXPAYER'S PREMISES**

**1102.35**

The auditor should arrange for a physical inspection of the premises with the store representative at an early stage in the formation of the audit program. Notations should be made during this inspection regarding any activities or departments which may involve unique problems in audit procedure or application of tax.

## **AUDIT PROGRAM**

**1103.00**

### **GENERAL**

**1103.05**

The auditor, having gained information at his initial meeting with store management and from his analysis of the accounting system and internal controls, is in a position to outline a tentative audit program. At this time all details cannot be included; however, the basic procedures can now be reduced to writing. Decisions as to the areas and the extent of detail to be examined will be made as the audit progresses and will be influenced by the volume of transactions, the availability of supporting records and commensurate time factors.

The Sales and Use Tax Law and Regulation 1698, Records, require every seller and consumer to keep records of all sales and purchases. Besides journals, ledgers, and other books of accounts typical of the business, all schedules and working papers essential to the preparation of the tax returns should be available, as well as sales and purchase orders, contracts, invoices and other documents of original entry.

The availability of records and supporting detail is an important factor in determining what test periods should be used. Once an agreement has been secured as to the use of the proposed test periods, it should be emphasized to the store representative that errors of a recurring nature so disclosed will be prorated throughout the audit period.

### **TOTAL SALES — GENERAL**

**1103.10**

Sales made through the departments are accounted for daily. Several days' transactions may be "batched" for purposes of recording to recapitulation summaries which in turn are journalized and then posted to the sales account. The measures employed to safeguard cash, inventories and other assets as well as to maintain proper functioning of the accounting system are varied and extensive. Among the methods used are: (a) the floor audit plan to insure the recording of all sales through the cash registers, (b) employment of shopping tests, (c) vigilance of a protective service, and (d) continuous testing by the store's Internal Auditor.

### **CYCLE BILLING**

**1103.15**

Charge accounts receivable are generally kept under a cycle billing system, the main features of which may be summarized as follows:

- a) Sales checks, credit slips, and remittance slips are sorted and filed alphabetically by customers' names in specially designed trays.
- b) There are usually 20 cycles ending on various days of the month (customers are assigned to the cycles in alphabetical order).
- c) Postings are made by means of accounting machines — from the checks and slips representing all the transactions for the month — to statements of customers included in that particular cycle.
- d) One by-product is a separate summary of the transactions on an account card maintained for each customer and another by-product is a proof sheet of the final balances of the individual accounts which serves as a trial balance.
- e) The customers' statements and supporting sales checks, etc., are photographed on microfilm and then mailed to the customers.

The accounts receivable department maintains a controlling account for each cycle and one for the total charge accounts. At each cycle billing date, the total of the trial balance per accounting machine proof sheet is compared with the cycle control. Differences of larger amount, say over \$200, are investigated. Smaller differences are written off to profit and loss. In this way, at each cycle billing date, the detail is in agreement with the control account. Under the cycle billing method, which has as its principal advantage the elimination of billing peaks, trial balances of the detail ledgers are staggered throughout the month. However, at the end of each calendar month the total of the charge accounts receivable as shown by the department cycle controls is reconciled to the general ledger control account.



## **ROUTINE SALES**

**1103.20**

Routine sales transactions fall into two main categories:

- a) "House" Departments:
  - 1) Departments selling the store's own merchandise and related services.
  - 2) Special store-owned departments appealing to customer convenience, their purpose being to attract customers to the store. Examples of such departments are: beauty salon, restaurant, custom gift wrap, etc.
- b) Leased departments operated by concessionaires selling their own merchandise and services:
  - 1) Departments reporting under the store's permit.
  - 2) Departments reporting under their own sales tax permit.

## **MISCELLANEOUS SALES**

**1103.25**

The auditor should be alert for taxable sales that are not accumulated through regular sales accounts. Ingenuity must be employed to identify these transactions. Such sales may be but are not restricted to: capital assets, shopping bags, supplies, sales through vending machines, sales to concessionaires and accommodation sales to employees or others.

## **CONCESSIONAIRES**

**1103.30**

Certain departments are leased to others under contracts which take various forms but the usual bases for payment of store occupancy to the lessor are:

- a) Percentage of net or gross sales with possible provision for minimum rental payment
- b) A fixed rental
- c) A profit-sharing arrangement

The general ledger should contain a clearing account for concessionaire operations. The store has sales tax liability for the operations of lessees who are not registered with the Board for the period of operation (Regulation 1699).

If there are concessionaires, the auditor should secure a complete list of all leased departments operated during the audit period, showing the department's name and number, address of operator, and the sales tax permit number, if any, held by lessee. Even though the department store does report the concessionaires' sales transactions, special attention should be given to the possible liability for use tax of the concessionaire for operating supplies, giveaways, etc., since these are often shipped into the State from the concessionaires' out-of-state home office or purchased from out-of-state retailers.

## **AUDIT INFORMATION**

**1103.35**

Sources of audit data available to the auditor include:

- a) General Ledger
- b) Journal entries and supporting data
- c) Cash Receipts Record
- d) Purchase Register
- e) Cyclical sales recaps or journals
- f) Cash register envelopes and enclosed detail, both cash and charge
- g) Sales contracts
- h) Sales tax work sheets
- i) Inventory Records
- j) Purchase Invoices
- k) Accounts Receivable Records

## **DEPARTMENT STORE SALES TAX AUDIT WORKING PAPERS**

**1103.40**

Due to complex management requirements imposed upon department store accounting systems, work sheets used in the preparation of sales and use tax returns usually are quite comprehensive. The detail involved in bringing together from various sources items such as total sales, purchases subject to use tax and deductions claimed, makes these work sheets valuable to the tax auditor. Careful study of them will help to acquaint the auditor with the flow of the tax accounting system and make him aware of the sources of tax data. The work sheets will lead him to other schedules prepared by the taxpayer and if the taxpayer has no objections, these may be photocopied and used in the audit verification.

To further acquaint himself with the accounting system, the auditor should trace samples of postings from the sales accounts in the general ledger back through the journal entries or monthly recapitulation to the weekly or other cyclical summary. Further back tracing should be made from original sales recaps to the departmental cash register envelopes containing the sales invoices.

### **EXAMINATION OF GENERAL LEDGER**

**1103.45**

General ledger accounts other than sales accounts must be examined for entries which may represent taxable transactions. As examples, merchandise sold at cost may have been credited to the purchase or other cost of sales account and debits to general ledger asset and expense accounts may include unreported purchases subject to use tax. The latter would be noted for consideration during the use tax phase of the audit.

### **EXAMINATION OF GENERAL JOURNAL**

**1103.50**

Transactions not found by examination of other records may be recorded in the general journal. The auditor should scan all general journal entries, noting those which may suggest significant taxable transactions such as disposal of capital assets and consumption of merchandise purchased for resale. Any data pertaining to these entries, such as working papers supporting large compound entries for items affecting the tax, should be examined.

In this connection, the auditor will generally find certain standard journal entries recurring each month which can usually be verified on a test basis, as well as miscellaneous entries for nonrecurring transactions which will be spread out over a larger cycle and require individual attention.

### **EXAMINATION OF CASH RECEIPTS JOURNAL**

**1103.55**

This record should be examined to locate any receipts from cash sales not usually accounted for through departmental sales. Examples of such sales are:

- a) Sales of capital assets
- b) Sales of shopping bags
- c) Sales of supplies
- d) Sales through vending machines
- e) Accommodation sales to employees and others

### **EXAMINATION OF PURCHASE JOURNALS OR ACCOUNTS PAYABLE REGISTERS**

**1103.60**

Entries may be found in these records which represent sales to employees or buyers of specially ordered merchandise. Sizable credits to purchases or expenses should be analyzed.

## AUDIT OF PURCHASES SUBJECT TO USE TAX

1104.00

### GENERAL

1104.05

Sales and use tax work sheets prepared by a department store usually contain identification of the items on which the taxpayer declared use tax. Use of these schedules for verification purposes will facilitate the audit work. The examination for use tax liability should follow general procedures outlined in Chapter 4.

### MERCHANDISE USED BY SERVICE DEPARTMENTS

1104.10

Service departments whose receipts are wholly or partially exempt from tax may consume merchandise in performing the service. Examples are those which repair or alter customer's property such as alterations, upholstery, radio and television, monogramming and engraving, jewelry, etc. Materials used by these departments may be purchased tax paid; however, they customarily are withdrawn from ex-tax inventory.

### REQUISITIONS FOR DEPARTMENTAL USE

1104.15

Accounting for merchandise withdrawn from inventory for use is accomplished by interdepartmental transfers or requisition forms. These forms may be individually recorded or may be periodically summarized for a journal entry debiting expense and crediting stock inventory. The auditor should examine such withdrawals for a suitable test period, tracing them to the taxpayer's work sheets.

### PROMOTIONAL MERCHANDISE

1104.20

Occasionally, sales promotions are conducted at the request of suppliers. A gift of the product may be made to sales personnel to encourage an added effort to sell the supplier's merchandise. The expense of the gifts is often borne by the supplier through charges called debit memos. Recording the cost of the gift will probably be made by debiting accounts payable and crediting merchandise inventory. The auditor should make test examinations of the debit memos to verify that tax has been accrued.

### MARKDOWNS FOR GIFTS OF MERCHANDISE

1104.25

In order to account for merchandise given to employees or others at the taxpayer's expense, markdown or price reduction memos are prepared to reduce the retail inventory accountability for such items to zero. These memos should be test-examined and traced to the use tax work sheets.

### RENTALS

1104.30

Rental receipts may be found in some departments such as music, appliance, etc. The auditor should follow the procedures outlined in Chapter 4 of the Audit Manual to test the accuracy of the taxpayers' reporting.

### PURCHASES SUBJECT TO USE TAX — MISCELLANEOUS

1104.35

The following kinds of transactions are among those which will require the auditor's special attention:

|  | <i>Directive</i>     |
|--|----------------------|
| Advertising and Display Material                             | Annotations 100.0000 |
| Gift Wrapping  | Regulation 1589      |
| Demonstration and Display (Loan of Merchandise)              | Regulation 1669      |
| Containers and Labels (Price Tags, Shipping Tags and Labels) | Regulation 1589      |
| Returns, Defects and Replacements                            | Regulation 1655      |
| Service Policies   | Regulation 1655      |
| Printing and Related Arts (Signs, Showcards and Posters)     | Regulation 1541      |
| Merchandise Warranties                                       | Regulation 1655      |

## AUDIT OF CLAIMED DEDUCTIONS

**1105.00**

### GENERAL

**1105.05**

Verification of allowable deductions from gross receipts is a major portion of a department store audit. It should be borne in mind that verification of many deductions may be performed simultaneously or combined with verification of total sales and use tax.

### SUPPORTING DETAIL

**1105.10**

As previously mentioned, cash register sales envelopes are the source for the summary detail of sales and deductions. The use of cycle billing by department stores makes it necessary for the auditor to thoroughly acquaint himself with the specific system under examination. Verification of invoiced amounts may be made from:

- a) Tissue copies of invoices that may be retained.
- b) Special microfilms of ex-tax sales invoices made to support sales tax exemptions.

It may be necessary for the auditor to project his findings on charge sales to cash sale transactions in those instances where cash sale invoices are not available for examination.

### SELECTION OF TEST PERIODS

**1105.15**

Selection of periods to be tested often will be determined by the availability of supporting detail. Review of department store audit procedures Section **1103.15** will assist the auditor in evaluating the need for testing certain deductions and in deciding whether to do so on a storewide or departmental basis. Time should be spent in the sales audit section reviewing a portion of the departmental sales invoices. This review will indicate the type of errors that may be found in the application of the tax to individual transactions. A week or comparable cycle which is a complete unit of operation is ideal for testing purposes except that it may be too extensive and time consuming for the audit of some stores. In the event that no batch or group of documents can be easily or conveniently tied into the records, it may be practical to use the "floating test" technique. In this test the auditor secures a batch of completed documents before they are sorted and entered into the records. A percentage of error is then established on the basis of this test. This test has proven very effective and generally may be relied upon to reflect the trend of taxpayer's accuracy in reporting. As in other audits, agreement with the store representative as to proposed test periods is desirable.

Statistically, it is possible to conclude whether a material error exists with a far smaller sample than would be necessary to reasonably measure that error. Notwithstanding anything said above, or any agreement with the department store representative, the auditor should keep in mind the desirability of abandoning any test of a particular phase of the audit as soon as he is reasonably assured that no material error exists.

### SALES FOR RESALE

**1105.20**

Sales to other retailers for purposes of resale are minor in most department stores. Verification generally may be limited to the few departments in which these sales occur. Reference should be made to Chapter 4 of the Audit Manual for audit procedure.

### SALES OF FOOD PRODUCTS

**1105.25**

Sales of food products for human consumption are usually made in the following departments:

- a) Restaurants and coffee bars
- b) Food, liquor and candy departments

In recent years there has been a trend towards operation of these departments by concessionaires. Verification of exempt food sales is discussed in Chapter 9. The following regulations are also pertinent: Regulation 1602, Food Products; Regulation 1602.5, Reporting Methods for Grocers; and Regulation 1603, Taxable Sales of Food Products.

## **RETURNS AND ALLOWANCES**

**1105.30**

This section supplements Audit of Returned Merchandise, and Audit of Cash Discounts, Sections in Chapter 4, of the manual. Amounts representing returns of merchandise sold and allowances on sales may be netted from gross receipts or reported as a deduction. Usually, review of returns and allowances is accomplished simultaneously.

General audit procedure outlined in Chapter 4 of the manual will be followed for items covered by Regulation 1655, Returns, Defects and Replacements. Allowances made to customers for price adjustments or complaints on quality, service, etc., are usually charged against the respective sales accounts or to a "Sales Allowance" account. Care must be taken to eliminate any credits for trade-ins from this deduction. Some retailers use a "Policy Adjustment" account to which unusual allowances are charged for lost merchandise, damage to customer's clothing, etc. Entries into this account may be claimed as returned goods in error. Auditor is also cautioned that many of the larger stores adjust some articles, especially tires, which have a value in their defective condition. The allowance should, therefore, be reduced by the amount of such value.

## **SALES IN INTERSTATE OR FOREIGN COMMERCE**

**1105.35**

Sales in interstate or foreign commerce to out-of-state consumers represent one of the larger deductions reported by department stores. Verification generally will be made on a test basis as outlined in Chapter 4. The large volume of transactions and custom of the trade ordinarily will justify acceptance of most invoices in support of the deductions which show shipping charges and indicate delivery to a point outside this State.

However, sales of furs, jewelry, etc. may be made to California residents who intend to use the property in California even though the delivery is taken outside of California. In such instances the application of the use tax must also be considered and resolved by the auditor. Section 6247 of the Sales and Use Tax Law covers transactions of this nature. For these reasons department stores should retain supporting documents since the use tax would apply unless it can be substantiated that the property was not purchased for use in California.

## **LABOR**

**1105.40**

Workrooms perform services for customers and sales departments. Their activities may result in sales or use tax liability. Examples of workrooms are: clothing alterations, drapery, floor coverings, major appliances, monogramming and engraving, radio and television, and jewelry repairs.

Labor charges to customers are made by sales departments on the basis of the labor or services performed by the workrooms. Charges for fabrication and assembly labor should be included in taxable sales but those for installation, repair or reconditioning services are allowable deductions. General auditing procedure of labor deductions is contained in Chapter 4.

Application of the tax to some types of services is not always well understood. The auditor may find taxable operations shown on the sales invoice merely as "labor" without any sales tax reimbursement.

## **BAD DEBTS**

**1105.45**

The provisions of Regulation 1641, Credit Sales and Repossessions, and Regulation 1642, Bad Debts, apply when considering bad debts as an allowable deduction. The auditor should also review the information included in Section 0419.01.

Certain retailers, such as department stores, are authorized to compute deductions on a formula basis. The Controllers Committee of the California Retailers Association has prepared a formula which relates carrying charges to charge sales. This formula has been authorized for the computation of allowable bad debt deductions. The formula follows:

FORMULA TO BE USED UNDER REGULATION 1642.  
IN DETERMINING SALES TAX CREDIT FOR BAD DEBTS

Prepared by  
 Controllers Committee  
 California Retailers Association

- ① Determine the relationship between taxable sales per the tax returns and gross charges per the books for the last available calendar year. In almost every retail store this calculation can be made from the normal quarterly reconciliations of book totals representing total net register sales with taxable sales per the return.

EXAMPLE:

|  |               |             |               |
|--|---------------|-------------|---------------|
| Gross registered sales per sales audit                                     |               |             | \$0.00        |
| Less gross returns and credits per sales audit                             |               |             | <u>0.00</u>   |
| (A) Net Register Sales   |               |             | \$0.00        |
| Add unallowable credits:   |               |             |               |
| Trade-ins  |               | \$0.00      |               |
| Market value of repossessions  |               | 0.00        |               |
| Expense Allowances included in credits                                     |               | 0.00        |               |
| Partial credit returns   |               | 0.00        |               |
| Miscellaneous unallowable credits  |               | <u>0.00</u> | <u>\$0.00</u> |
| SUB TOTAL  |               |             | \$0.00        |
| Less exempt transactions:  |               |             |               |
| Sales for resale   |               | \$0.00      |               |
| Sales of food products   |               | 0.00        |               |
| Sales to U.S. Government   |               | 0.00        |               |
| Out of State sales   | \$0.00        |             |               |
| Less Shipping Charges incl'd.  | (0.00)        |             |               |
| Fed. Excise Tax included   | <u>(0.00)</u> | \$0.00      |               |
| Federal Excise Tax   |               | 0.00        |               |
| Retail Sales Tax   |               | 0.00        |               |
| Other exempts:   |               |             |               |
| Sales of merchandise certificates run on register                          |               | 0.00        |               |
| Hunting and fishing licenses run on register                               |               | 0.00        |               |
| Shipping charges.  |               | 0.00        |               |
| Non-taxable sales in cost and leased workroom departments.                 |               | 0.00        |               |
| Non-taxable sales of concessions included in sales per our return.         |               | 0.00        |               |
| Sales of concessions who report their own sales tax.                       |               | 0.00        |               |
| Miscellaneous exempts  |               | <u>0.00</u> | <u>\$0.00</u> |
| (B) Taxable Merchandise Sales per return before taking bad debt deduction. |               |             | <u>\$0.00</u> |

Annual percentage of taxable sales per return to net register sales

(B) Merchandise Sales per Return  
 (A) Net Register Sales

- ② Determine the relationship of carrying charges to charge sales as follows:

|           | SALES LESS RETURNS<br>PLUS CARRYING CHARGE<br>CALENDAR YEAR | CARRYING CHARGE<br>CALENDAR YEAR | PERCENT    |
|-----------|---|----------------------------------|------------|
| 30 Day    | \$0.00  | \$0.00                           | 0.0        |
| Revolving | 0.00  | 0.00                             | 0.0        |
| Scrip     | 0.00  | 0.00                             | 0.0        |
| Lease     | <u>0.00</u>   | <u>0.00</u>                      | <u>0.0</u> |
|           | \$0.00  | \$0.00                           | 0.0% (z)   |

Determine average number of carrying charge assessments made while accounts were delinquent prior to their being assigned for collection or charged off. This can be done by either:

- 1) Using the period established by store policy during which delinquent accounts are generally kept active prior to assignment or charge off, or
- 2) Analyzing 25% of the accounts being written off on the quarterly return to determine the average number of carrying charge assessments made during delinquency. After this has been done on a quarterly basis for one year it need only be done once each calendar year.

Apply the average number of carrying charge assessments while accounts were delinquent as follows:

|  |     |     |
|--|-----|-----|
| Carrying charge reflected in bad debt accounts prior to delinquency. This is percentage obtained above (z).  | (z) | 0.0 |
| Portion of bad debt accounts attributable to items other than carrying charge prior to delinquency (100 – z) | (a) | 0.0 |
| Rate of carrying charge  | (b) | 0.0 |

#### DELINQUENT MONTH No. 1

|  |     |             |
|--|-----|-------------|
| Balance due on bad debt accounts before accounts became delinquent                             | (c) | 100         |
| *Plus carrying charge levied on accounts dueing first month of delinquency (b x c)             | (d) | <u>0.00</u> |
| Equals balance due at end of first month (c + d)   | (e) | 0.00        |
| Total amount of carrying charge in balance (e – a)   | (f) | 0.00        |
| Percentage of balance at end of first delinquent month attributable to carrying charge (f ÷ e) |     | 0.0%        |

#### DELINQUENT MONTH No. 2

|  |                   |             |
|--|-------------------|-------------|
| Balance due at beginning of second month   | (c <sub>1</sub> ) | 0.00        |
| *Plus carrying charge levied on accounts during second month of delinquency (b x c <sub>1</sub> )                          | (d <sub>1</sub> ) | <u>0.00</u> |
| Equals balance due at end of second month (c <sub>1</sub> + d <sub>1</sub> )   | (e <sub>1</sub> ) | 0.00        |
| Total amount of carrying charge in balance (e <sub>1</sub> – a)  | (f <sub>1</sub> ) | 0.00        |
| Percentage of balance at end of second delinquent month attributable to carrying charge (f <sub>1</sub> ÷ e <sub>1</sub> ) |                   | 0.0%        |

\*If the limited sampling method is used and the average number of assessments results in a fraction, this fraction will be applied to the last delinquent month at this step in the formula. This adjustment is accomplished by multiplying the product obtained (d<sub>z</sub>) by the fraction.



DELINQUENT MONTH No. 3

|  |                   |             |
|--|-------------------|-------------|
| Balance due at beginning of third month  | (c <sub>2</sub> ) | 0.00        |
| *Plus carrying charge levied on accounts during<br>third month of delinquency (b x c <sub>2</sub> )                          | (d <sub>2</sub> ) | <u>0.00</u> |
| Equals balance due at end of third month (c <sub>2</sub> + d <sub>2</sub> )  | (e <sub>2</sub> ) | 0.00        |
| Total amount of carrying charge in balance (e <sub>2</sub> - a)  | (f <sub>2</sub> ) | 0.00        |
| Percentage of balance at end of third delinquent month<br>attributable to carrying charge (f <sub>2</sub> ÷ e <sub>2</sub> ) |                   | 0.0%        |

- ③ Determine the ratio of recoveries to charge offs for the two preceding fiscal years:

|                            | I<br>TOTAL CHARGE OFFS<br><u>LAST TWO YEARS</u>         | II<br>TOTAL RECOVERIES<br><u>LAST TWO YEARS</u> | III<br>NET LOSS |
|----------------------------|---|---|-----------------|
| 30 Days                    | \$0.00  | \$0.00  | \$0.00          |
| Revolving                  | 0.00  | 0.00  | 0.00            |
| Scrip                      | 0.00  | 0.00  | 0.00            |
| Lease                      | <u>0.00</u>   | <u>0.00</u>                                     | <u>0.00</u>     |
|                            | \$0.00  | \$0.00  | \$0.00          |
| Average net loss percent – | $\frac{\text{Total Column III}}{\text{Total Column I}}$ |   |                 |

- ④ Having made the calculations involved in ① to ③ proceed to make the calculations for the quarterly return as follows:
- Apply the percentage obtained in ③ to the total accounts being written off. Thus, anticipated future recoveries are taken into consideration at time of charge off and only expected eventual net loss is used as the basis for deduction on the sales tax return.
  - Reduce the amount obtained in (a) by the amount of carrying charge included as determined by average percentage obtained in ②. Thus, carrying charge element included in net charge off is eliminated.
  - Reduce the result obtained in (b) by the percentage determined in ①. Thus, the gross write-offs for the quarter have been reduced in eventual net loss after deducting carrying charges and reducing from gross to taxable sales as originally claimed in return.

It is important to note that as a result of these calculations that even though a customer's account being written off contains charges arising from sales made by concessions reporting their own sales and some non-taxable sales by concessions included in company return, some exempt workroom sales, carrying charge, etc. the application of these formulas results in a completely equitable deduction for bad debts for purposes of the return. If each charge off and recovery had to be analyzed and scheduled, the retailer could not afford to make the calculations involved, nor could the State afford to audit them. Under this method the State always has the use of the money representing the tax effect of anticipated future recoveries which in view of saving in clerical cost is well worth the sacrifice to the retailer.

\*If the limited sampling method is used and the average number of assessments results in a fraction, this fraction will be applied to the last delinquent month at this step in the formula. This adjustment is accomplished by multiplying the product obtained (d<sub>2</sub>) by the fraction.



MEMO ONLY

Illustration of application of Step 2 of formula, assuming delinquent accounts kept active an average of three months:

|        |  |                 |   |
|--------|--|-----------------|---|
|        |  | 100.000%        |   |
|        | (z)  | 6.000%          | Relationship of carrying charges to charge sales.   |
|        | (a) (100% - z)                                       | 94.000%         | Portion excluding carrying charges.   |
|        | (b)  | 1.500%          | Established rate of delinquency penalty.  |
| Mo. 1  | (c)  | 100.000%        | Balance due including unpaid portion of original carrying charges before account became delinquent. |
|        | (d) (b x c)  | <u>1.500</u>    | Add delinquency charge (not carrying charge).   |
|        | (e)  | <u>101.500</u>  | Balance due at end of first month.  |
|        | (f) (e - a)  | <u>7.500</u>    | Amount of delinquency and carrying charge.  |
|        | (f ÷ e)  | <u>7.389%</u>   | % of balance applicable to (f).   |
| Mo. 2  | (c <sub>1</sub> ) (e)                                | 101.500         |   |
|        | (d <sub>1</sub> ) (b x c <sub>1</sub> )              | <u>1.523</u>    |   |
|        | (e <sub>1</sub> ) (c <sub>1</sub> + d <sub>1</sub> ) | <u>103.023</u>  |   |
|        | (f <sub>1</sub> ) (e <sub>1</sub> - a)               | <u>9.020</u>    |   |
|        |  | <u>8.755%</u>   |   |
| Mo. 3  | (c <sub>2</sub> ) (e <sub>1</sub> )                  | 103.023         |   |
|        | (d <sub>2</sub> ) (b x c <sub>2</sub> )              | <u>1.545</u>    |   |
|        | (e <sub>2</sub> ) (c <sub>2</sub> + d <sub>2</sub> ) | <u>104.568</u>  |   |
|        | (f <sub>2</sub> ) (e <sub>2</sub> - a)               | <u>10.568</u>   |   |
|        |  | <u>10.106%</u>  |   |
| Proof: |  | 104.568%        | Balance end of 3rd month at write off.  |
|        |  | x <u>10.106</u> |   |
|        |  | <u>10.568</u>   |   |
|        |  | 104.568         |   |
|        |  | <u>10.568</u>   |   |
|        |  | <u>94.000</u>   | Portion excluding c/c (a)   |

**CASH REGISTER SHORTAGES****1105.50**

Questions are frequently raised about amounts classified as "cash register shortages". Factors which may cause differences between sales recorded on the cash register and cash and valid sales checks received are as follows:

1. Sales are rung on the cash register incorrectly, are then re-rung correctly, but the sales clerk fails to cancel (void) the first ring.

Erroneous duplicate over-rings are allowable as a reduction of sales.

2. Sales are recorded on the register for more than the actual sales amount; for example, a \$1.00 item rung on the register as \$10.00. The reverse (under-rings) also occur.

Over-rings and under-rings are to be treated as a reduction or addition to sales recorded on the cash

register.

3. Charge sales checks have illegible or missing credit card imprints or handwritten customer names. (These are billed as an unidentifiable receivable and subsequently written off to cash register shortage.)  
Illegible charge sales checks are considered as worthless or uncollectible accounts. Accordingly, such uncollectible sales qualify as a bad debt deduction. However, any amounts which are subsequently collected should be reported.
4. Charge sales checks are lost prior to billing.  
Charge sales checks lost prior to billing are considered as uncollectible accounts qualifying as a bad debt deduction.
5. Employee or other theft from register.  
These amounts are not allowable as a reduction of sales. When money is stolen, there is not a question as to whether or not consideration was received.
6. Charge sales checks indicated by sales person as cash and therefore never billed to the customer.  
These are considered to be worthless accounts similar to items 3 and 4.
7. Counterfeit money received.  
Sales paid for by counterfeit money, fraudulent checks or unauthorized charge plates are allowable reduction of sales. However, the reduction is limited to the original sales amount. Losses attributable to counterfeit money or fraudulent checks in excess of the original sale are not allowable.
8. Cash register change errors.  
Change errors are not to be treated as an adjustment to recorded cash register sales. Such errors are similar to lost or stolen money. The change error occurs after consideration for the merchandise has been received. Any recourse against a customer who has received excessive change would be based on the fact that he has money which belongs to the store. It would not be based on lack of consideration received for the merchandise purchased.

Differences which are claimed as a reduction of cash register sales must be supported by the facts on hand. The analysis of a representative test period should, in fact, substantiate that any one, or a combination of the factors enumerated, does support a reduction in cash register sales in the amounts and to the extent claimed.

## **FEDERAL EXCISE TAX**

**1105.55**

Gross receipts subject to sales tax include the amount of any manufacturer's or importer's excise tax included in the price of the merchandise, whether or not separately stated.

Taxable receipts do not include any federal tax, with respect to a retail sale, imposed upon the retailer or consumer such as a federal tax on the sale of jewelry, luggage, furs, etc., (Regulation 1617, Federal Taxes.). However, retailers must retain records to show that the amounts deducted as federal tax have been returned to the United States or will be returned to the United States in accordance with Section 4053 of the Internal Revenue Code.

## **SALES TAX INCLUDED**

**1105.60**

The auditor may find, due to departmentalized accounting functions, varied methods of accounting for sales tax accruals within the store. The auditing procedure will be adapted accordingly. Two of the methods are:

- a) Sales tax is rung up on a special key on the cash registers and the accumulated amounts are determined by the sales audit department.
- b) Sales tax is buried in the gross amount rung up in the cash registers. The tax included is determined by a formula which is computed periodically.

The accuracy of the methods used to accrue the tax should be tested. Any significant differences should be analyzed.

## **LOCAL AND TRANSACTIONS TAXES**

**1106.00**

### **GENERAL**

**1106.05**

Local and transactions tax problems similar to those encountered in audits of a wide variety of individual retail establishments may be found in the audit of a single department store. These problems are complicated by the volume of transactions occurring during the audit period, the centralized accounting for operations of many locations, and the specialized requirements for department store management. Determination of the place of sale requires special consideration in audits of stores with locations in two or more taxing jurisdictions. Mail orders add more complications since they may be taken in one tax area for shipment from another.

### **LOCAL SALES AND USE TAX**

**1106.10**

A difficult part of the local tax audit of a department store is the verification of the jurisdictional allocations made by the retailer. As in other audits concerned with this problem, the auditor must ascertain, from testing a group of transactions, that the tax was correctly accumulated by jurisdiction.

If reallocation of local tax reported is necessary, the auditor should be guided by provisions of Business Taxes General Bulletin 59–12 and the limitations imposed by Section 7209 of the Sales and Use Tax law.

## **DISCOUNT DEPARTMENT STORES**

**1107.00**

### **GENERAL**

**1107.05**

In recent years a new type of retail merchandising has become quite popular with the advent of the discount department store. These stores are usually located in suburban areas around large metropolitan cities. They offer a wide variety of merchandise including clothing, hardware, drugs, furniture, jewelry, alcoholic beverages, etc. Many of the newer stores have a complete grocery super market in the same building.

A discount department store may cater to members only or may be open to the general public. While the discount department stores handle the same general type of merchandise as the regular department stores, the audit problems are not so extensive. A preliminary contact should be made to arrange for starting the audit, as in all large audits.

### **TYPES OF DISCOUNT DEPARTMENT STORES**

**1107.10**

Stores are departmentalized according to type of merchandise. Some of the departments are operated by the store and usually departments such as jewelry, alcoholic beverage and grocery are leased out to independent operators. Auditor should verify that all leased departments have permits.

Sales are primarily for cash. Financing is available for larger appliance items, such as washing machines, refrigerators and television sets. The recent trend is toward some type of credit arrangement for all purchases, to compete more effectively with regular department stores.

### **TOTAL SALES**

**1107.15**

As sales are principally for cash, and cash is usually under good control, the auditor can make a limited examination on cash sales. Usually a daily report is made on each cash register, showing register readings, cash count and reconciliation. These cash reports are posted to a work sheet; work sheet totals to a combined cash and sales journal; and monthly or weekly totals are posted from the sales journal to the sales account in the general ledger.

Postings should be tested from source documents through the various entries to the general ledger sales account. The extent of such tests would depend on the type of controls maintained by the taxpayer.

Contract sales will probably be entered individually in a sales journal. These sales may contain nontaxable items, such as delivery charges, installation labor, television warranties and interest charges. A test should be made on contract sales to verify that the above items are non-taxable and that tax was charged only on the sales price prior to the addition of nontaxable items. Discount houses do not generally accept trade-in merchandise on appliance sales.

### **MISCELLANEOUS SALES**

**1107.20**

These sales may consist of employee sales, equipment sales or other unusual sales as noted under Section [1103.25](#).

### **OTHER EXAMINATIONS**

**1107.25**

Sections [1103.30](#), [1103.40](#), [1103.45](#) and [1103.50](#) apply to discount department stores in the same manner as regular department stores, and the auditor's examination should be guided by these sections.

### **DEDUCTIONS**

**1107.30**

The examination of deductions comprises one of the major differences in auditing a discount department store as opposed to a regular department store. The auditor may find deductions for food products, resales, interstate sales and labor. Verification of such deductions should be made in the normal manner.

Unless the taxpayer also operates a grocery department the deductions will be small in relation to total sales and usually easily verified.

## **PURCHASES SUBJECT TO USE TAX**

**1107.35**

The auditor should follow the same procedure as outlined in Sections [1104.05](#) through [1104.35](#). Particular attention should be given to the purchase of equipment for new stores and promotional merchandise given away in connection with the opening of new stores.

## REGULATIONS PERTINENT TO DEPARTMENT STORES

1108.00

In examining sales detail the auditor will find many kinds of transactions which have special problems in application of the tax. Following is a listing of some of those common to department stores

### *Directive*

|                                  |                       |
|----------------------------------|-----------------------|
| Altering Furs .....              | Reg. 1549             |
| Cash Discounts .....             | Reg. 1671, 1700       |
| Concessionaires .....            | Reg. 1699             |
| Construction Contracts .....     | Reg. 1521             |
| Delivery Charges .....           | Reg. 1628             |
| Draperies .....                  | Reg. 1521, 1526       |
| Engraving .....                  | Reg. 1526             |
| Food Products .....              | Reg. 1602, 1602.5     |
| Furnishing Displays .....        | Reg. 1669             |
| Gift Wrapping .....              | Reg. 1589             |
| Lay-Away Sales .....             | Annotations 200.0160  |
| Lease Contracts .....            | Reg. 1641, 1642, 1660 |
| Meals .....                      | Reg. 1603             |
| Merchandise Traded In .....      | Reg. 1654             |
| Merchandise Warranties .....     | Reg. 1590             |
| Newspapers and Periodicals ..... | Reg. 1592             |
| Optometrists .....               | Reg. 1660             |
| Rentals .....                    | Reg. 1521             |
| Television Antenna .....         | Reg. 1655             |
| Vending Machines .....           | Reg. 1574             |